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Outlook for 2004–2006: Ukraine's economy headed for a soft landing

Because the situation on world markets continues to be very favorable, the ICPS forecast for economic growth in 2004 has been upgraded from 10% to 13.5%. As world markets soften somewhat, Ukraine's economy will also have a soft landing, with the pace of real GDP growth slipping to 9% in 2005 and to 7% in 2006. The main risks to this prognosis are overheating in the domestic economy and sharp fluctuations on global commodities markets. Read all about this forecast in the latest issue of Quarterly Predictions

Ukraine's economic upswing is in its fifth year now. GDP is outpacing even the most optimistic expectations. Preliminary data for H1'04 indicate that the economy grew 12.7%. The base for this economic boom remains an unprecedentedly positive external market situation, the adaptation of the population to market realities, and growing purchasing power among consumers.

Throughout H1, there was a trend for exports of goods and services to grow at a noticeably faster pace than imports. This was helped by extremely favorable conditions for Ukrainian exports:

- continuing escalation of prices for key commodities on export markets;
- rapid economic growth among trading partners, especially Russia; and
- the expansion of the EU in May, which led to a spike in exports to the countries that were about to join.

High growth rates should continue throughout 2004

The ICPS forecast for real GDP growth in 2004 has been upgraded to 13.5%. This is mostly due to the exceptionally favorable external situation, higher economic growth among trading partners, and higher Budget spending than had been anticipated. Among the key components of this fast growth are construction, which grew 24%, trade (22%), and industry (15%), thanks to the high prices for Ukrainian metals and chemicals on foreign markets, high rates of domestic consumption, and a steady increase of investment in manufacturing. ICPS economists expect public consumption to rise 18% in connection with the rise in wages, pensions and other social payments prior to the presidential election in October. At 29% of GDP, Budget spending will be slightly higher than last year.

In connection with the gradual stabilization of world prices for commodities, the pace of growth of exports and imports will taper off. Still, the high balance of trade, the growth of FDI, and the amount of remittances from migrant Ukrainian workers will generate a record-high current account balance of US $5.3bn or 8.5% of GDP. The high level of foreign currency inflows will lead to rapid accumulations of gold and currency reserves and a minor nominal revaluation of the exchange rate.

The CPI will grow 6.5%. The slightly lower pace of price rises in 2004 will be made possible by a much better harvest than in 2003, as well as Government anti-inflation measures aimed at ensuring that the spike in producer prices not be felt on the consumer market. The PPI will rise 20%.

The economy is likely to slow down in 2005–2006

According to ICPS, a softening in the external situation and slower growth among Ukraine's main trading partners will contribute to a slowdown in Ukraine's economy over 2005–2006. 2005 should see a slightly higher pace of growth (9%) than anticipated earlier, given the multiplier effect of the high level of growth in 2004. The forecast for 2006 remains unchanged at 7%.

The main growth factor will be external demand as private consumption will slow somewhat and investment demand will be unstable.

Table 1. Key macroeconomic indicators

Year	2003	2004	2005	2006
Indicators	(est.)		(forecast)	
GDP, billons UAH	264.2	335.8	402.6	456.7
Real GDP, apc*	9.4	13.5	9.0	7.0
Real industrial output, apc	15.8	15.0	9.5	8.0
Real agricultural output, apc	9.9	10.0	3.5	2.5
Real gross fixed investment, apc	15.8	16.0	14.0	10.0
Real consumption, apc	12.8	14.4	7.9	9.3
Consumer price index, apc	8.2	6.5	8.0	5.0
Real wages, aapc**	24.0	24.0	18.0	15.0
Unemployment rate (ILO methodology), %	9.1	8.5	8.2	8.0
Exports of goods&services, apc	24.0	28.0	13.0	7.0
Imports of goods&services, apc	28.7	21.0	16.0	12.0
Current account balance, % GDP	5.8	8.5	7.5	3.7
Consolidated Budget balance, % GDP	-0.2	-2.0	-0.5	-1.0
Official exchange rate (average annual), UAH/USD	5.33	5,32	5.25	5.17

** apc = annual percentage change*
*** aapc = average annual percentage change*

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions

As the list of major state assets slated for privatization shrinks and global lending rates rise, the Government will have fewer options for additionally financing the Budget deficit and this will require a policy of smaller deficits. Indeed, there is a risk that the Government will allow greater financial gaps should it begin to institute serious reforms or in the run-up to the parliamentary election in 2006.

A worsening of the conditions for foreign trade will gradually reduce the current account balance to US $3.3bn in 2006 or 3.7% of GDP. This, in turn, will lead to a lower money supply and less pressure on prices, which will support the Government's anti-inflation measures.

Preparations for Ukraine's accession to the WTO and the impossibility of using revaluation to reduce pressures on the money supply through an emission of currency, in the opinion of ICPS, will force the NBU to review the current system of currency regulation. This should strengthen the nominal revaluation of the hryvnia against the dollar.

An overheating economy needs a soft landing

The exceptionally high pace of growth of Ukraine's economy brings with it some risk of overheating. Economists understand "overheating" as excessively high economic growth, especially the kind that is driven by unfounded public spending and risks a rapid rise in inflation and a sudden industrial slowdown, at the same time as industrial capacities are overloaded.

Although it is still impossible to speak about an overheating economy in 2004 since the current brisk growth is largely driven by the revival of capacities that were at a standstill for some time, the risk of the economy suddenly putting on the brakes is growing. Ukraine's heating up is accompanied by rapidly rising producer and manufacturer prices to 14.3% during H1'04. Coke, oil products, metals and industrial electricity have grown the fastest. The last time such high growth rates were observed was in 2000, when the Government carried out a decisive battle with barterization.

In developed countries, the domestic market is usually the shock absorber of any consequences of a decline. But the Ukrainian economy is currently mostly oriented towards exports: these constituted 58.6% of GDP in 2003 and 72% of GDP in Q1'04. The main exporting sector in Ukraine is industry, whose gross value-added was 29% of GDP in 2003. Specifically, the main exporting branches are mining and metallurgy, chemicals and machine-building—all of whom strongly depend on the situation on world markets.

With the improvement of world markets for steel products and trade based on a severely depreciated hryvnia since the 1998 crisis, the share of domestic consumption of metal products has gone down sharply. And although exports are relatively diversified, the lion's share of steel products ends up in Southeastern Asia, particularly China. Thus, should China succeed in its policy of replacing imports by domestic production or if Ukraine faces severe trade restrictions, then there will be a crisis of overproduction.

At the moment, according to ICPS, the sectors that are oriented on the domestic market make up only 40% of the economy, although they are showing clear signs of growing faster than average. Among them is relatively high-tech manufacturing, such as vehicle makers who could eventually start using domestic steel output. This would soften the negative impact of an overheating economy should world markets nosedive—but it would not entirely eliminate it.

Even if overheating is avoided, ICPS economists still expect consumer inflation to grow to 8% in 2005. The peak of this growth will likely be in the first quarter.

In short, ICPS specialists believe that the Government needs to begin to take steps to stimulate the development of domestic markets and sell the idea of a soft landing, that is, a moderate slowdown in the pace of economic growth as soon as there is any evidence that foreign demand for Ukrainian products is shrinking. Moreover, in 2005–2006, it will make little sense to continue to stimulate consumption by simply reducing taxes and rapidly increasing social spending.■

*For more analysis of economic trends in H1'04 and the outlook for Ukraine's economic development in 2004–2006 read **quarterly predictions** #27. For subscription information, contact Maksym Korepanov by telephone at (380-44) 236-5464, or via e-mail at marketing@icps.kiev.ua. For additional information about ICPS economic forecasts, contact Andrew Blinov by telephone at (380-44) 236-1292, or via e-mail at ablinov@icps.kiev.ua.*

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